

STATE OF CALIFORNIA

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June 26, 1998



Attorneys At Law

Re: **Interspousal Transfer in Redemption of Partnership Interests Following Marital
Dissolution: Deed Presumption.**

Dear Mr. :

This is in response to your letter of December 22, 1997, in which you have requested our opinion concerning the change in ownership consequences of the following fact situation:

1. Muriel and Walter dissolved their marriage in 1996, and a Final Judgment on Consolidated Matters ("Judgment"), ordering the division of their real property and assets, was filed on July 23, 1996. Among the properties subject to transfer as a result of the Judgment is the "O'Farrell Street" property in
2. At that time, the O'Farrell Street property was one of the properties owned by ("PTA"), a California limited partnership, composed of Walter, Muriel, the Trust ("Trust"), and others. Walter was an income beneficiary and a trustee of the Trust.
3. The Judgment settled the division of the community property of Walter and Muriel in PTA, by ordering distribution of property (O'Farrell Street) to Walter in an amount equal to his capital account representing his partnership percentage interest in PTA.

4. The distribution was accomplished by means of a redemption of Walter's PTA interest in exchange for PTA's transfer of the O'Farrell Street property to Walter's wholly owned corporation, ("Corporation"). through a consolidation of the following steps:
 - (1) PTA distributed an undivided 62.67% interest in O'Farrell Street to Walter in complete redemption of his general partnership interest in PTA;
 - (2) PTA distributed an undivided 37.33% interest in O'Farrell Street to the Trust in partial redemption of its partnership interest in PTA, and the Trust distributed that 37.33% interest in O'Farrell Street to Walter in complete liquidation of his interests in the Trust;
 - (3) Simultaneous with the distributions of O'Farrell Street to Walter, Walter transferred O'Farrell Street to Corporation;
 - (4) Walter withdrew from PTA, and the partnership interests in PTA were reconfigured with no single partner acquiring more than 50% of the total partnership capital and profits;
 - (5) Walter resigned as a trustee of the Trust, and the Trust was reformed removing him as a beneficiary of the Trust.
5. All of these transfers were undertaken by the parties, for convenience purposes, by a single deed from PTA to Corporation.

Your question is whether the Interspousal exclusion in Section 63(e) would apply to the distribution of O'Farrell Street from PTA to Corporation. For the reasons hereinafter explained, we believe that it would not apply, because the Corporation cannot qualify as a spouse, unless the deed presumption is rebutted.

LEGAL ANALYSIS

Distribution of Partnership Property to Spouse under Section 63(e).

Revenue and Taxation Code section 63 (e) codifies Article IX A, section 2, subdivision (g)(3) of the California Constitution and specifically excludes from change in ownership:

(e) The distribution of a legal entity's property to a spouse or former spouse in exchange for the interest of such spouse in the legal entity in connection with a property settlement agreement or a decree of dissolution of a marriage or legal separation.

By express language, the "Interspousal exclusion" extends to the distribution of legal entity property, including partnership property, to a spouse in exchange for the interest of such

spouse in the legal entity, when made in connection with a decree of dissolution. The term "distribution of a legal entity's property to a spouse" in exchange for the interest of such spouse in the legal entity is critical to the correct application of the exclusion in this case. The meaning of this language has been well established since the enactment of this provision, that any transfer between spouses made in connection with a property settlement agreement or a judicial decree to finalize their property rights, is excluded from change in ownership. This includes transfers undertaken through a partnership redemption allowing one of the spouses to withdraw from the partnership, providing that no individual or entity remaining in the partnership gains control under Section 64(c). However, this provision does not include and has never been construed to include transfers in which the transferee is a spouse's corporation and not the spouse.

As the legislative history indicates, subdivision (e) of Section 63 was added by AB 152, Chapter 1141 of Statutes of 1981 for the purpose of applying the Interspousal exclusion to the distribution of assets of a legal entity when a marriage was dissolved. (See Letter to Assessors No. 81/152, p.2, (11/6/81) copy attached.) The need for this provision became obvious to taxpayers and assessors who noted that without it, spouses who held their real property in a legal entity had their property subjected to change in ownership and reappraisal whenever, as the result of the dissolution of their marriage, one spouse had to withdraw from the entity and redeem his/her interest in the entity in exchange for a transfer of real property from the entity. Prior to the amendment, spouses who had interests in legal entities owning real property were treated differently than spouses who held property in co-tenancy or joint tenancy, and were thus deprived of any benefit under this aspect of the Interspousal exclusion. The clear intent of the legislation was stated in the rule amendment added in 1982, which provides unequivocally that property distributed from a partnership, corporation or other legal entity to a spouse under a redemption plan decreed in the dissolution of a marriage is within the Interspousal exclusion.¹

What is not included in either the amended statute or the rule interpreting the statute is an extension of the Interspousal exclusion to a transfer between spouses and legal entities (see Annotation No. 220.0180 - Ochsner Memorandum 3/27/87, enclosed). Thus, while the exclusions set forth in the statute takes precedence over all other change in ownership provisions, those exclusions apply only to transfers "between spouses."

In analyzing the facts here, it is quite clear that all of the transfers described in the court's Judgment as necessary for the parties to accomplish the redemption of Walter's total partnership interests in PTA seem to be within the Interspousal exclusion. That is, up to the point where the parties deeded the O'Farrell Street property from PTA to Corporation, every step was within the Section 63(e) exclusion. Walter and Muriel held community property interests in the partnership. In dividing these interests for purposes of dissolving their marriage, the court determined, through appraisals and financial analyses, that a redemption of Walter's total interests in PTA, and PTA's distribution of the O'Farrell Street property to Walter, would properly accomplish the community

¹ Rule 462.220(h) also contains the same language providing for this exclusion: the distribution of property of a corporation, partnership, or other legal entity to a spouse or former spouse having an ownership interest in the entity, in exchange for the interest of such spouse in the legal entity in connection with a property settlement agreement or decree of dissolution of a marriage or legal separation.

property division. O'Farrell Street was apparently the PTA asset which was equivalent in value to the value of Walter's community property share in the total partnership interests of PTA.²

That several steps were necessary to accomplish the redemption would not have disqualified the spouses from receiving the benefit of the Interspousal exclusion, since each step was, in effect, part of the redemption plan ordered by the court. Thus, Walter's direct interest in PTA as a partner was to be redeemed through PTA's transfer of 62.67% of O'Farrell Street to Walter. Walter's indirect interest in PTA as a trustee/beneficiary of the Trust (a partner) was to be redeemed through PTA's transfer of 37.33% of O'Farrell Street to the Trust, and then the Trust's distribution of that same interest in O'Farrell Street to Walter. Following Walter's redemption and withdrawal, the PTA partnership interests were reconstituted, and no person or entity apparently acquired, either directly or indirectly, more than 50% of the total PTA interests. Proceeding under these steps, Walter as an individual, not his Corporation, would have received the O'Farrell Street property, and the Interspousal exclusion in Section 63(e) would have excluded the transfer from change in ownership and reappraisal.

Deed Transfer to Corporation rather than Spouse.

The deed transfer actually undertaken by the parties, as indicated in your October 7, 1998 letter to the County Assessor's office, was different than the steps ordered in the Judgment, in that PTA did not transfer O'Farrell Street to Walter, but to Corporation. Unfortunately, this difference causes an entirely different end result, since the transferee is a Corporation and not a spouse.

It is your view that the documentation by single deed of all of the steps ordered in the Judgment is a mere formality "for convenience purposes" only, and that it is intended to reflect the court Judgment establishing Walter (the spouse redeemed out of the partnership) as the 100% owner of the O'Farrell Street property. This viewpoint, however, makes two assumptions which appear to be inconsistent with pertinent law. First, this assumes that a transfer to the Corporation rather than to Walter as an individual should not have a meaningful difference in the outcome (presumably because Walter is the sole 100% shareholder in his Corporation). Secondly, this viewpoint assumes that the deed transferring the O'Farrell Street property to the Corporation does not mean what it says, and that the parties intended something other than the names memorialized in the deed.

With respect to the first assumption, whenever a transfer to or from a corporation or other legal entity occurs, the statutory scheme for determining a change in ownership is based upon the "entity theory" rather than the "ultimate ownership theory." This means that the corporation or

² In determining the amount that should be distributed to Walter in redemption of his partnership interests, the Court stated on p.2 that it had 1) determined the fair market value of the partnership assets, 2) computed the gain/loss that would result from the sale of such assets, 3) allocated that gain/loss to the partners' capital accounts, and 4) ordered distribution of real property to Walter in an amount equal to his capital account balance.

other legal entity, not the individual(s) comprising the entity, is treated as the "property owner."³ The "entity theory" was adopted in order to maintain relative parity between individual homeowners and businesses, and partnerships, corporations or other legal entities. That is, a partnership, corporation, or legal entity should be treated as an individual "entity" to whatever extent possible. Further, the Legislature determined that when a new legal entity is created, (i.e., a corporation files articles with the Secretary of State), and assumes ownership and control of the property previously owned by the individual who created the entity (e.g., corporation assumes control of it shareholder's property), there has been a "transfer" of property from an individual to an entity, even though the new "shareholder" and the percentage of ownership interests the shareholder owns in the property remain the same. This theory was codified in Section 61(j) by classifying as a change in ownership, "The transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partners, or any other person." Therefore, apart from the application of an exclusion, the transfer of the O'Farrell Street property from the partnership (PTA) to the Corporation constitutes an entity-to-entity transfer resulting in a change in ownership of the property transferred.

As discussed above, the Interspousal exclusion in Section 63(e) is not applicable, and the exclusion in Section 62(a)(2) would also not be applicable. The proportional interest exclusion under Section 62(a)(2) excludes from change in ownership, "any transfer between an individual or individuals and a legal entity or between legal entities, ... , which results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer."⁴ It is quite clear in the instant case that the respective PTA partnership interests in the O'Farrell Street property were not proportional to Walter's corporate shareholder interests in the property after the deed transfer. The transfer was not merely a change in the method of PTA and the Corporation holding title to the property.

In regard to the second assumption, the assessor, by statute cannot ignore a deed transfer, and cannot refuse to reassess the property, if the transfer is not excluded from change in ownership. Under Rule 462.200 (b), the assessor must presume that the persons/entities listed on the deed, in fact, hold the ownership interests in the property. If this presumption is not rebutted, "any transfer between the parties will be a change in ownership. Where, however, the taxpayer wishes to challenge the deed, claiming that it does not accurately reflect the present beneficial interests in the property transferred, the burden of proof is on the taxpayer to provide "clear and convincing proof" (Evidence Code Section 662) that the owner of legal title as shown on the deed

³ See the "Report of the Task Force on Property Tax Administration" presented to Assembly Committee on Revenue and Taxation, Willie J. Brown, Jr., Chairman, January 22, 1979, recommending the statutory language in Sections 61 and 64 reflecting several basic principles accepted by the Task Force.

⁴ With regard to partnerships specifically, Rule 462.180 (e)(1) states that "Except as provided in (b)(2) [analogous to Section 62(a)(2) above], when real property is contributed to a partnership or is acquired, by purchase or otherwise, by the partnership, there is a change in ownership of such real property, regardless of whether the title to the property is held in the name of the partnership or in the name of the partner(s), with or without reference to the partnership. Except as provided in (b)(2), the transfer of any interest in real property by a partnership to a partner or any other person or entity constitutes a change in ownership.

is not the owner of beneficial title, and never received present beneficial use of the property. As to the type of taxpayer documentation that would rebut the presumption, Rule 462.200 (b) is instructive:

(b) Deed Presumption. When more than one person's name appears on a deed, there is a rebuttable presumption that all persons listed on the deed have ownership interests in property, unless an exclusion from change in ownership applies.

In overcoming this presumption, consideration may be given to, but not limited to, the following factors:

(1) The existence of a written document executed prior to or at the time of the conveyance in which all parties agree that one or more of the parties do not have equitable ownership interests.

(2) The monetary contribution of each party. The best evidence of the existence of any factor shall be an adjudication of the existence of the factor reflected in a final judicial finding, order, or judgment. Proof may also be made by declarations under penalty of perjury (or affidavits) accompanied by such written evidence as may reasonably be available, such as written agreements, canceled checks, insurance policies, and tax returns.

In all matters such as this, the assessor must ultimately make a factual determination based upon all of the evidence submitted. We have not been provided with the deed, any agreements that may have been executed between the parties at the time, relevant corporate documents (or a holding agreement), or the decree of dissolution with its attached exhibits or declarations, which would tend to support a conclusion other than that the Corporation received true beneficial ownership of the O'Farrell Street property. Therefore, we cannot provide any definitive answers in this regard.

However, in a recent telephone discussion, you asked us to address the general change in ownership consequences that could result, if the deed presumption is rebutted by the taxpayer. In answer to your request, we note that there seem to be three possible conclusions the assessor could reach, depending upon the type of evidence submitted:

1. That the deed transfer from PTA to the Corporation was a technical error, not reflecting the intent of the parties, and therefore voidable, allowing the parties to rescind the transfer and redo the transaction properly (with Walter as the transferee). The probable result of such rescission and retransfer to Walter would be the assessor's enrollment of the previous base year value (plus the appropriate inflation adjustment) as of the rescission date. However, no refund of taxes would be paid during the period that the new base year value from the 1996 change in ownership was in effect.

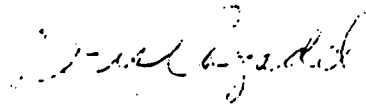
2. That the deed transfer from PTA to the Corporation was invalid and void from its inception as it was technically inconsistent with the Court's Judgment. Rescission would not be

necessary since the deed was void. No change in ownership would have occurred. (See Annotation No. 220.0871, McManigal Letter 9/25/89, attached.) The property would revert back to its previous adjusted base year value and enrolled with the appropriate inflation adjustment as of the date of the voided deed; any taxes paid during the period that the new base year value was in effect should be refunded.

3. That the deed transfer from PTA to the Corporation reflected the delivery of mere legal title. As you suggested, there may be other documents, such as a "holding agreement" or some instruments related to the property settlement plan, which directed that the Corporation was to take and to hold title to the O'Farrell Street property on behalf of Walter, and that it would not have any equitable or beneficial interest in the property. If such holding agreement satisfies the agent/principal criteria set forth in Rule 462.200 (c), then the deed transfer would not constitute a change in ownership, since the Corporation holds only legal title and Walter is the true beneficial owner of the property.⁵ (See Annotation No. 220.0250, Eisenlauer Letter 8/17/89, enclosed.) No change in ownership would have occurred. The property would revert back to its previous adjusted base year value and enrolled with the appropriate inflation adjustment as of the date of the deed; any taxes paid during the period that the new base year value was in effect should be refunded.

The views expressed in this letter are, of course, only advisory in nature. They are not binding upon the assessor of any county or any person or entity.

Very truly yours,



Kristine Cazadd
Senior Staff Counsel

KEC:ba

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Attachments: Annotations Nos. 220.0180, 220.0871, and 220.0250
Letter to Assessors No. 81/152, p.1-2.

⁵ (c) Holding Agreements. A holding agreement is an agreement between an owner of the property, hereafter called a principal, and another entity, usually a title company, that the principal will convey property to the other entity merely for the purposes of holding title. The entity receiving title can have no discretionary duties but must act only on explicit instructions of the principal. The transfer of property to the holder of title pursuant to a holding agreement is not a change in ownership. There shall be no change in ownership when the entity holding title pursuant to a holding agreement conveys the property back to the principal.

(1) There shall be a change in ownership for property subject to a holding agreement when there is a change of principals.

(2) There shall be a change in ownership of property subject to a holding agreement if the property is conveyed by the holder of title to a person or entity other than the principal.